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DE RUEHSN #1028/01 3032102
ZNR UUUUU ZZH
R 302102Z OCT 09
FM AMEMBASSY SAN SALVADOR
TO RUEHC/SECSTATE WASHDC 1816
INFO RUEHZA/WHA CENTRAL AMERICAN COLLECTIVE
RUCPDOC/USDOC WASHDC
RUEATRS/DEPT OF TREASURY WASHINGTON DC

UNCLAS SAN SALVADOR 001028

STATE PASS USTR
STATE ALSO PASS USAID/LAC

SENSITIVE
SIPDIS

E.O. 12958: N/A
TAGS: EFIN ECON PGOV ES
SUBJECT: SALVADORAN FISCAL REFORMS RAISE CONCERNS

REF: SAN SALVADOR 906

¶1. (U) This is an action request. Please see paragraph 9.

¶2. (SBU) SUMMARY. The Government of El Salvador has unveiled a fiscal reform package intended to cover revenue shortfalls and meet International Monetary Fund (IMF) targets. The proposed tax on alcoholic beverages may have trade agreement implications. Leading think tanks have called the reforms overly complex and poorly developed, while the private sector has publicly opposed the effort. Reform is necessary given El Salvador's fiscal problems, but the current proposal is likely to generate less revenue than expected while fueling inflation and/or reducing economic growth. END SUMMARY.

¶3. (U) The Ministry of Finance presented a sweeping fiscal reform package for public comment on October 18, with plans to present a final package to the National Assembly on November 15. Totaling over 200 pages, the reforms change 13 laws and include over 100 regulatory modifications. The reforms include new or increased taxes on petroleum, alcohol, non-alcoholic beverages, tobacco, and on interest earned on bank deposits. The package includes changes to the existing value-added and income taxes but does not change rates. The Ministry projects to raise $220-230 million in new revenue, part of its effort meet IMF commitments to reduce its budget deficit and increase tax receipts as percent of GDP (reftel).

¶4. (SBU) One change raises potential CAFTA-DR and/or WTO concerns. The proposed alcoholic beverage tax applies a higher rate to whiskey and gin, which are imported, than to beer, rum, or vodka, which are produced domestically. (NOTE: El Salvador's existing alcohol taxes are also likely not in CAFTA-DR/WTO compliance. END NOTE.) USTR and Econcouns have raised this in general terms with Vice Minister of Economy Roger Hernandez, stressing the need to ensure all tax reforms are trade agreement compliant.

¶5. (U) On October 29, leading center-right think tank FUSADES released a preliminary opinion, calling for additional time to analyze the complex reforms. In general, however, FUSADES recommends a simpler tax structure and government policies that promote economic growth as the best way to raise revenue.

¶6. (SBU) Dr. Roberto Rubio, head of the center-left think tank, FUNDE, told Econ Staff that fiscal reform is absolutely necessary, even in a recession, since the government simply does not have the funds to cover its expenses. What matters, according to Rubio, is the quality of the reform. He said the GOES had acted too quickly, not thought through a coherent political strategy, and not properly analyzed the economic effects of the reforms. He worried that the reforms were so big that the entire effort would get bogged down in the National Assembly. He also expressed concern that a new tax on petroleum, which will affect almost all businesses, will have an inflationary effect when passed on to consumers.

¶7. (SBU) The Salvadoran private sector has publicly expressed opposition to the reform and concern about the effects of the tax changes on business and investment. Mario Magana, Economic Issues Director for the Salvadoran Chamber of Commerce, advised Econ Staff that the Chamber opposed the fiscal reform across the board but planned to focus its efforts on the 30 changes they see as most damaging to business. Magana and Waldo Jimenez, his counterpart at the private business association ANEP, both expressed dismay that the GOES refused to consider spending cuts or a private concession for the Port of La Union as alternatives to address the budget shortfall.

¶8. (SBU) COMMENT: El Salvador's fiscal woes and commitments to the IMF necessitate some sort of fiscal reform. The package presented, however, will most likely fail to deliver as much revenue as projected, as consumers and businesses shift their behavior away from the new taxes, potentially hindering economic growth. The private sector's opposition runs the risk of being dismissed as "rich people not wanting to pay their taxes," and will need to be focused, as the Chamber has suggested, on modifying the items that have the most potentially damaging effect. The reform package is still likely to bog down when it moves to the Assembly. With the split within the traditionally pro-business ARENA bloc, however, it may pass more easily than expected if the ARENA dissidents are "persuaded" to vote with the FMLN.

¶9. (SBU) ACTION REQUEST: Post requests specific guidance from Washington for a formal demarche on the trade agreement implications and potential violation of the proposed tax on alcoholic beverages. Post has provided copies of the proposals to USTR and Commerce/MAC.
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